Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:WAS:RCH:TL-N-6765-00
CMDRees

date: 08 JAN 2000

to: James R. Schmidt, Manager, Engineering and Valuation
31 Hopkins Plaza, Rm. 1040, Baltimore, MD 21201

from: Cheryl M.D. Rees
Senior Attorney

subject: [redacted]

Statute of Limitations: [redacted]

DISCLOSURE STATEMENT

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ISSUES

1. Whether [redacted] [hereinafter referred to as [redacted]] realized a deductible loss under some section of the Internal Revenue Code in regard to its [redacted] parcel of land on [redacted] in [redacted] or [redacted].

2. If [redacted] did sustain a loss, in what taxable year should it be recognized?

3. Whether, if a loss was sustained, it is equal to the gross difference in FMV before and after the "taking" (less reimbursements), or must a different valuation method be used.

4. If no loss is allowable for tax purposes, what is the proper treatment of the $[redacted] and $[redacted] paid to [redacted] by the [redacted] and the [redacted], respectively?

CONCLUSIONS

1. It is our opinion that [redacted] did not realize a deductible loss as a result of actions taken by the [redacted] or the [redacted] between [redacted] and [redacted].

2. Since it is our opinion that [redacted] did not sustain a recognizable loss, the question of the timing of any loss is moot. Because we believe that any such loss would have been deductible in years prior to [redacted], however, it is our opinion that the question of timing presents a strong alternative position that may help you achieve an agreed case.

3. As a result of our response to Issue 1, Issue 3 is moot.

4. We do not have the facts necessary to determine the proper treatment of the $[redacted] paid to [redacted]. As a general matter, however, it is our opinion that, if the payments constituted reimbursement for lost future income, they should be reported as ordinary income. If, on the other hand, they did not, it is our opinion that the payments should be applied to reduce [redacted]'s cost basis in the entire property.

FACTS

Beginning in [redacted] or earlier, the [redacted] Government followed an informal policy called the "[redacted]." Under this policy, the Government would not issue building permits for buildings [redacted] or to the [redacted], where the [redacted] is located, without the approval of the [redacted].

In [redacted], [redacted] purchased a [redacted]-acre parcel of land at [redacted] near [redacted], for $[redacted]. At the time of [redacted]'s purchase, the property bore a [redacted] building that was later demolished by the taxpayer. The property [redacted]. Most of the [redacted] was zoned [redacted] and could have had a building with a [redacted] of [redacted] built thereon. Some of it, however, was zoned [redacted] which could have only had a [redacted] built thereon.

The facts regarding the details of [redacted]'s negotiations with various departments of the [redacted] government and the [redacted] vary as they are set forth in court documents[1] and other documents you forwarded to our office. [redacted]

[redacted]

[redacted]

[redacted]

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[1] All but one of the court documents forwarded to our office were prepared by [redacted]. Please be aware that these contain allegations and legal arguments made by [redacted] rather than facts that have been determined to be true.

[2] [redacted]

[redacted]

[redacted]

Also in [redacted], while the suit between [redacted] and the [redacted] suit was pending, the [redacted] filed a suit to quiet title against [redacted] and the [redacted] claiming a sole ownership or, in the alternative an exclusive easement over a strip of land known as [redacted]. According to the claims of the [redacted] Government, [redacted] abutted [redacted]'s property or was a part of [redacted]'s property over which it had an exclusive use easement. The [redacted] claimed that it had declared the street a [redacted] in the [redacted]'s. In its land use plan, however, [redacted] intended to use the street to access its property.

On [redacted] the [redacted]

and [redacted] entered into a settlement resolving both lawsuits. According to the terms of the settlement, [redacted] quitclaimed any interest it might have had in [redacted] to the [redacted] and agreed to forego all claims or potential claims with regard to the development of the [redacted] property. [redacted] agreed to withdraw its [redacted] Permit Application and submit a new one reflecting its changed plans for developing the property. Under the new plan, it intended to build a [redacted] with [redacted]. The [redacted] agreed to expedite [redacted]'s application for a permanent private driveway permit on part of its property so that it could access a public right-or-way known as [redacted]. It also agreed to expedite the processing of [redacted]'s application for a building permit. The questions of the ownership of [redacted] and the easements pertaining thereto were purposely left unresolved. Finally, the [redacted] agreed to pay [redacted] $[redacted], and the [redacted] agreed to pay [redacted] $[redacted] without specifying the justification for these payments.

By check dated [redacted], the [redacted] paid [redacted] $[redacted]. [redacted] alleges that it did not receive the check until [redacted]. On [redacted], the [redacted] paid [redacted] the $[redacted] to which it had agreed.

[redacted]'s representative has informed the Service that the [redacted] parties to the agreement never discussed the breakdown of the claim(s) to which the $[redacted] in payments pertained. We have never contacted the representatives of the [redacted] or the [redacted] to determine whether they agree with this assessment. [redacted], however, has never alleged that any of the sum was attributable to the [redacted] question. It has never commissioned an appraisal relating to [redacted].[3] Instead, in [redacted], it commissioned two appraisals relating to the claimed diminution of value of its property caused by the refusal of the [redacted] to approve its [redacted] building permit application. In both valuations, it offset the $[redacted] in payments against the loss determined.

On its [redacted] tax return, [redacted] claimed a loss under I.R.C. § 1231 in the amount of $[redacted] based on a claimed loss in property value of $[redacted] due to the alleged "taking" of [redacted]'s property on [redacted] by [redacted]'s refusal to issue a permit

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[3] We did have a summary appraisal done that concluded that, even if [redacted] had held a fee simple interest in [redacted], it sustained no loss when it agreed with the [redacted] and the [redacted] to forego use of [redacted] in exchange for access to the [redacted].

without an approval from the [redacted] offset by the $[redacted] 'reimbursement' it received. The Service obtained a valuation that the diminution in value of [redacted]'s property due to its inability to obtain approval of the building permit in [redacted] was $[redacted] which needed to be reduced by the $[redacted] in payments received, leaving a reduction in value of $[redacted]. The group assigned the examination of [redacted]'s return has, therefore, proposed an adjustment to the loss claimed by [redacted] on its [redacted] return in the amount of $[redacted] ($[redacted] - $[redacted]). They have informally conveyed this information to the taxpayer who has tentatively agreed to the adjustment. The manager of the Engineering and Valuation Group, however, believes that the taxpayer sustained no recognizable loss in [redacted] or [redacted] and, in fact, received taxable income when the payments were received.

We do not know what method of accounting the taxpayer uses. Although the taxpayer's [redacted] taxable year remains open until [redacted], its [redacted] taxable year does not remain open.

ANALYSIS

Issue 1

I.R.C. § 165(a) provides generally that a deduction is allowable for any loss sustained during a taxable year for which the taxpayer does not receive reimbursement of any kind. Treasury Regulation § 1.165-1(b) adds that, in order to be deductible under I.R.C. 165(a), a loss must be, "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year." Treas. Reg. § 1.165-1(b); see Treas. Reg. § 1.165-1(d); United States v. White Dental Manufacturing Co., 274 U.S. 398, 401, 403 (1927); Lakewood Associates v. Commissioner, 109 T.C. 450, 456 (1997). The mere reduction in value of property does not, alone, establish a loss for purposes of I.R.C. § 165(a). The reduction in value must be accompanied by some action that fixes the time and the amount of the loss, such as the sale, exchange or abandonment of the property. See United States v. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927); Lakewood Associates v. Commissioner, 109 T.C. 450, 456, 459 (1997).

If a taxpayer does recognize a gain or loss from the sale, exchange or involuntary conversion of real and depreciable property used in a trade or business, I.R.C. § 1231 determines the characterization of the gain or loss. See I.R.C. § 1231; Treas. Reg. § 1.1231-1. In order for the taxpayer to substantiate its claimed ordinary loss under the circumstances presented herein, it would have to prove that it had sustained the partial or total destruction of its property through the

exercise of the power of requisition or condemnation, or the threat or imminence thereof. See, I.R.C. § 1231; Treas. Reg. § 1.1231-(e); Lakewood Associates v. Commissioner, 109 T.C. 450, 461 (1997).

The United States Tax Court and other courts have long held that government land use regulations, including local zoning laws or Federal regulations, such as wetland regulations, rarely constitute a condemnation of property under eminent domain powers. See Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992); United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985); Agins v. City of Tibouron, 447 U.S. 255 (1980); Lakewood Associates v. Commissioner, 109 T.C. 450, 461 (1997). In those unusual cases in which a taking was found, it was because the land use regulation either failed to substantially advance legitimate state interests or denied the owner of the affected land all economically feasible use of his land. See United States v. Riverside Bayview Homes, Inc., 474 U.S. 121, 126-27 (1985); Agins v. City of Tibouron, 447 U.S. 255, 260(1980); Penn Central Transp. Co. v. New York City, 438 U. S. 104, 138, n. 36 (1978); Nectow v. Cambridge, 277 U.S. 183, 188 (1928). In United States v. Riverside Bayview Homes, Inc., the Supreme Court explained:

> We have frequently suggested that governmental land-use regulation may under extreme circumstances amount to a 'taking' of the affected property. . . . we have made it quite clear that the mere assertion of regulatory jurisdiction by a governmental body does not constitute a regulatory taking. [Citations omitted.] The reasons are obvious. A requirement that a person obtain a permit before engaging in a certain use of his or her property does not itself 'take' the property in any sense: after all, the very existence of a permit system implies that permission may be granted, leaving the landowner free to use the property as desired. Moreover, even if the permit is denied, there may be other viable uses available to the owner. Only when a permit is denied and the effect of the denial is to prevent 'economically viable' use of the land in question can it be said that a taking has occurred.

474 U.S. 121, 126-27 (1985).

In our advisory opinion dated August 13, 1999, we drew a distinction between a possible taking of any interest [redacted] may have had in [redacted] and a possible taking due to the denial of a building permit to [redacted] by the [redacted] government. [redacted], however, has never alleged that any portion of the $[redacted] in payments it received, or any of the damages or loss it claimed are attributable to the [redacted] question. It has only valued a loss relating to the denial of a building permit by the [redacted]. On its [redacted] return it claimed a loss attributable to the denial of the building permit and offset the entire $[redacted] against that loss. We do not have sufficient facts to form the basis of an analysis of the [redacted] issue.[4] Therefore, we will not consider that issue in our discussion. (b)(5)(AC) [redacted].

(b)(7)a [redacted].

When [redacted] purchased the property in [redacted], it bore a [redacted] building and was zoned in two different zones. On one part of the property, a [redacted] building would have been allowed. On the other, only a [redacted] would have been allowed. Thus, no part of the plans that formed the basis of [redacted]'s application for a building permit would have been allowed under the zoning that existed on the property when it was purchased by [redacted] (a [redacted] building on one side of the property and a [redacted] building on the other side).

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[4] From the observations made by the Service's expert, it appears that [redacted] may have received a greater benefit in the agreement than any rights it may have given up in the Quitclaim deed, even if the $[redacted] is not attributable to [redacted]. This may be the reason [redacted] did not pursue a loss relating to [redacted].

For at least two years prior to [redacted]'s purchase of the property, the [redacted] followed an informal policy called the "[redacted]" under which the government would not issue building permits for buildings [redacted] or to the [redacted] unless the [redacted] approved of the proposed building. The policy was not formalized until [redacted] the [redacted] overturned the [redacted]'s denial of [redacted]'s building permit on the ground that the [redacted] had not relied on any law or regulation in denying the building permit on the ground that the permit was not approved by the [redacted]. The [redacted]'s decision was overturned and the case remanded upon appeal.

[redacted] first filed an application for a zoning change and for approval of a Planned Unit Development on its property. This application was denied in [redacted] of [redacted]. The zoning commission based its denial on the ground that [redacted]'s plans did not afford adequate [redacted] and that the planned construction would interfere [redacted]. Thus, even if the building permit had not been denied, the lack of approval by the zoning commission would have prohibited [redacted]'s plans. We have no information indicating that [redacted] appealed the zoning commission's denial. On [redacted], the zoning commission created the [redacted]. Under the [redacted], no part of [redacted]'s property could have a building in excess of [redacted].

Between the time of the filing of its application with the zoning commission and the denial of its application, [redacted] filed the application for a building permit. [redacted] denied the application on [redacted] explaining that, after it conferred with the [redacted], the [redacted]'s attorneys had advised [redacted] that the permit should be denied to ensure the [redacted]. As noted above, [redacted] did appeal the denial by [redacted]. The [redacted] ordered that the permit be issued. In response to the [redacted]'s order, [redacted]. On [redacted] filed suit against the [redacted] in an attempt to compel it to approve the building permit. Before the court could resolve the parties' disputes, [redacted], the [redacted] and the [redacted] entered into an agreement dated [redacted] in which they settled all of their disputes with [redacted].

On its [redacted] return, [redacted] claimed that a loss arose on

[redacted], the date on which the [redacted] first denied its building permit. According to its claim, it was the act of the denial that caused its loss.

Although we did not find a case dealing specifically with the denial of a building permit, the rational in cases that considered denials of rezoning applications and denials of permits based on Federal wetland regulations is broad enough to cover the denial of building permits. Furthermore, the denial of the building permit was consistent with the denial of [redacted]'s rezoning application. The permit could not have been granted once the rezoning application had been denied. As was the case with the denial of rezoning applications and requests for permits in wetland areas, the denial of the building permit did not fix the time and the amount of a loss as would have a sale, exchange or abandonment of the property. Thus, according to the cases cited above, I.R.C. § 165(a) and Treasury Regulation § 1.165-1(b) would preclude deduction of the loss because it was not "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year." Treas. Reg. § 1.165-1(b).

In considering the requirements of I.R.C. § 165(a), the Tax Court has explained that:

> Land use regulations are akin to market conditions that are constantly subject to change. If we treated an adverse zoning decision or land use regulation as a loss realization event, it would then be necessary to treat increases from these sources as a taxable gain to the property owner.

Lakewood Associates v. Commissioner, 109 T.C. 450, 460 (1997). The issuance of building permits, closely related in many respects, are equally subject to change.

As noted in the cases cited for their analysis of I.R.C. § 1231, in order to show that it falls within the provisions of I.R.C. § 1231, [redacted] would have to show that it had sustained the partial or total destruction of its property through the exercise of the power of requisition or condemnation. See, I.R.C. § 1231; Treas. Reg. § 1.1231-(e); Lakewood Associates v. Commissioner, 109 T.C. 450, 461 (1997). It is unlikely that a court would find that the zoning and building permit regulations and policies followed by the [redacted] either failed to substantially advance legitimate governmental interests or denied [redacted] all economically feasible use of its land. See discussion

and cases cited at pages 8 and 9, supra.[5] (b)(7)a

Issue 2

Even if had realized a loss, the timing of its deduction presents a problem for the partnership. First, there is the question of whether identified the proper date of any loss. determined its loss to have taken place on , the date on which formally denied its request for a building permit. Since 's application for rezoning of its property had been denied in of and that denial prohibited the proposed development of the property, it is curious that determined its loss did not occur until the following year. Even if we overlook the denial of the rezoning application, the fact that appealed the denial of its request for a building permit to the casts doubt on the choice of as the date of a loss. On , the ordered that the building permit be issued to immediately. , filed suit in of the on . On , the court ordered that the building permit be issued. Thus, as of early , it looked as if the building permit would be issued and no possible loss sustained. In , however, the court order was appealed and overturned and the case remanded for further proceedings. The further proceedings never took place because of the agreement signed in between , the and the . Thus, it is arguable that it was not clear that the building permit would not be granted until sometime after , if not the date of the agreement in .

Even if we accept, for the sake of argument, that sustained a loss on , Treasury Regulation § 1.165-1 would lead us to conclude that was the latest year for claiming the deduction. Treasury Regulation § 1.165-1(d)(2)(i)

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[5] We could make a more knowledgeable analysis if we knew the justification set forth by the and the for paying $ and $ respectively. (b)(7)a

provides that:

> If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

Id. The question of whether a reasonable prospect of recovery exists is a question of fact that should be resolved through an examination of all of the facts and circumstances. Id. We do not have facts from which we can determine whether it could have been ascertained with reasonable certainty that [redacted] would receive $[redacted] or some other amount prior to [redacted]. We do know that, as of the date of the agreement dated [redacted], it could be ascertained with reasonable certainty that [redacted] would receive $[redacted] and only $[redacted] in reimbursement for its claimed loss. Even though [redacted] claims that it did not receive the monies until early [redacted], it was not necessary to receive the money to achieve reasonable certainty once the agreement dated [redacted] was drawn up.

It is our opinion that an alternative position disallowing deduction of the claimed loss in [redacted], based upon the provisions of Treasury Regulation § 1.165-1(d)(2)(i), would strengthen the Government's overall position in this case.

Issue 3

As a result of our response to Issue 1, Issue 3 is moot.

Issue 4

Responding to this issue is the most difficult task you have presented, in large part because we still do not know what motivated the [redacted] and the [redacted] to pay the $[redacted] to [redacted]. It may be that contacting the persons you represented the governmental entities in negotiating the settlement with [redacted] would enable you to discover the facts we now lack. It is really quite necessary to know the source of or justification for the payments in order to properly characterize them as either ordinary income or as chargeable to a capital account. It seems most likely that the governmental units deemed

the payments either as damages for lost future income, as an award for the exercise of eminent domain or as payment for something akin to an easement prohibiting development to the extent wished by [redacted]. (b)(7)a [redacted].[6]

In computing the amount of its claimed loss, [redacted] included a computation of lost rental income it attributed to the loss in the allowable [redacted] of the building it proposed. If the sums paid by the governmental entities were designed to compensate [redacted] for lost future income, it is clear that the sums should be reported in the year(s) received, if [redacted] was a cash basis taxpayer, or in the year in which they were accrued, if [redacted] kept its books on the accrual basis. See I.R.C. § 61; Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960); Inaja Land Co., Ltd. v. Commissioner, 9 T.C. 727 (1947).

(b)(7)a [redacted].[7] Our position assumes that any loss that may have been sustained through an adverse permit determination, though not realized or recognized at the time of the denial of the permit, is capital in nature and will impact the amount of the gain or loss realized when the affected property is sold, exchanged or abandoned. See discussion and cases cited at Issue 1, above. Therefore, if the governmental agencies clearly paid the $[redacted] because they believed the court might hold them liable for a condemnation or involuntary conversion, we believe that the sums paid should be considered as capital in nature and deducted from the taxpayer's basis in either the entire property or only the improvements thereon. We would justify such treatment under the broadly-stated, general rule of I.R.C. § 1016(a) that a proper adjustment to a property's basis shall be made for receipts properly

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[6] In the cases discussed with respect to Issue 1, there was no situation in which the governmental entity made a payment to the taxpayer.

[7] (b)(7)a [redacted].

chargeable to the capital account. I.R.C. § 1016(a).

Our final alternative might be to rely upon the rationale set forth by the Tax Court in Inaja Land Co., Ltd. v. Commissioner, 9 T.C. 727 (1947). Although the case is quite old, it remains good law and continues to be noted by contemporary legal commentators. See Marvin A. Chirelstein, Federal Income Taxation, A Law Student's Guide To The Leading Cases And Concepts 30-32 (1997). Most importantly, it provides a practical possibility for resolving a difficult question. In Inaja, both the Service and the taxpayer agreed that the City of Los Angeles had taken a right of way and perpetual easement over Inaja's property and paid Inaja therefore. The Court agreed with the taxpayer in holding that no part of the sum paid constituted compensation for the loss of past or future profits or income. Thus, no part of the sum paid needed to be reported as ordinary income. Id. at 732-35. The Court determined that the technically proper way for Inaja to report the gain or loss from the transaction would be to compute its basis in the portion of the property that constituted the right-of-way and perpetual easement and then compute the gain or loss in regard to the sum received. Id. at 735. The Court, however, carved out an exception to the required treatment when the apportionment of the basis of the entire property between the easement and the remaining property rights would be "wholly impracticable or impossible." Id. The Court went on to find that, since apportionment "with reasonable accuracy" in Inaja's case was not possible and the amount Inaja received was less than its basis in the entire property, no portion of the payment in question should be considered as income, but the full amount had to be treated as a return of capital and applied in reduction of Inaja's cost basis of the whole property. Id. at 735-36.

Note that the difficulty in apportioning the basis with reasonable accuracy in Inaja did not arise because the Court or parties did not know the facts. Rather, it was because of the nature of the interest conveyed. If we learn the parameters of an interest the governmental entities in our case believed was condemned or conveyed and that interest can not be reasonably or practicably defined or apportioned, we could rely on the Court's rationale in Inaja to conclude that the $[redacted] received by [redacted] should be applied in reduction of [redacted]'s cost basis in the entire property.

[redacted](b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a [redacted].

If we may be of additional assistance, please contact me directly at (804) 916-3947. Because we are sending this memorandum to the National Office for post review, please do not take action based upon our opinion herein until 30 days after the date of this memorandum. Due to the eminent statute of limitations date, we will contact you if we hear from the National Office prior to that date. Of course, you should feel free to contact the representatives of the [redacted] and the [redacted] to obtain the information discussed above as soon as possible.

/s/ Cheryl M.D. Rees

CHERYL M.D. REES
Senior Attorney (LMSB)